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A legal update from Dechert's Financial Services Group

SEC Proposes Two New "Hedge Fund" Rules

The U.S. Securities and Exchange Commission ("SEC") recently held an open meeting to discuss a variety of issues related to the U.S. securities markets, including new means of protecting investors in certain pooled investment vehicles. This update describes two new rule proposals approved for publication at that meeting that would affect hedge funds and their advisers.

In the course of the meeting, the SEC unanimously agreed to propose a new rule under the U.S. Investment Advisers Act of 1940 ("Advisers Act") to address fraud in pooled investment vehicles ("Anti-Fraud Rule"), and to propose a new rule under the U.S. Securities Act of 1933 ("1933 Act") to redefine "accredited investor" for the purpose of investing in some, but not all, privately offered investment vehicles (the "Accredited Natural Person Rule").[1]

Background

The SEC's proposed rulemaking follows the *Goldstein v. SEC* case, in which the U.S. Court of Appeals for the District of Columbia Circuit vacated a rule that effectively required many hedge fund advisers to register with the SEC.[2] The vacated rule redefined "client" for purposes of the "private adviser exemption" under the Advisers Act.[3] Now, as was the case prior to enactment of the now-vacated rule, the Advisers Act defines the collective vehicle, rather than its owners, as the client for the purposes of registration.

In overturning the rule, the court read the investment adviser's fiduciary obligations to private fund investors under the Advisers Act narrowly, stating that the fiduciary obligation of a hedge fund manager is owed to the fund and not necessarily to the individual investors in the fund.

The Anti-Fraud Rule

The SEC relied on Section 206(4) of the Advisers Act ("Statutory Anti-Fraud Requirement") in proposing the new Anti-Fraud Rule, mainly because the court in *Goldstein v. SEC* had called into question whether similar provisions in the Advisers Act were applicable to hedge fund advisers, but the court failed to subject the Statutory Anti-Fraud Requirement to the same scrutiny.

The Statutory Anti-Fraud Requirement makes it unlawful for any adviser to "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and provides that "[t]he [SEC] shall for purposes of [the Statutory Anti-Fraud Requirement] by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive, or manipulative."

The proposed Anti-Fraud Rule would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that pool.[4]

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1 *Prohibition of Fraud by Investors to Certain Pooled Investment Vehicles; Accredited Investors in certain Private Investment Vehicles,* SEC Release No. IA-2576 (Dec. 2006) ("Proposing Release").

2 *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). *See also Dechert OnPoint*: *Court Overturns SEC Hedge Fund Rule* (June 2006).

3 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, SEC Release No. IA-2333 (Dec. 2004).

4 Proposed Rule 206(4)-8 under the Advisers Act.

The language of the rule closely tracks the Statutory Anti-Fraud Requirement and is "designed to apply more broadly to deceptive conduct that may not involve statements."[5]

The rule would apply to all investment advisers to pooled investment vehicles, regardless of whether the adviser is registered under the Advisers Act or not. Under the proposed rule, a pooled investment vehicle would include any investment company and any company that would be an investment company but for the exceptions from the definition of investment company provided by Sections 3(c)(1) and 3(c)(7) of the U.S. Investment Company Act of 1940 ("Investment Company Act").[6]

Importantly, the proposed rule lacks a requirement that an investment adviser show an intention to defraud and therefore would impose a low negligence threshold for liability. The rule does not, however, give rise to a private right of action.

At the SEC open meeting, several of the Commissioners appeared to be uncomfortable with the fact that the proposed Anti-Fraud Rule does not delimit any *per se* frauds, making each investment adviser fraud claim under the proposed rule a case-by-case factual inquiry. Commissioner Roel Campos disagreed with the regulatory approach of the rule, noting that it "does not impose a specific ongoing disclosure obligation" on investment advisers.

Commissioner Paul Atkins questioned the staff on possible *per se* fraud, such as the failure to disclose so-called "side letters," that provide certain investors with special treatment. However, the SEC staff members maintained that they had consciously not included substantive regulation in the proposed new rule in an effort to deny would-be defrauders a roadmap for circumventing the regulation.[7]

The Accredited Natural Person Rule

In addition to approving for publication the proposed Anti-Fraud Rule for hedge fund advisers, the SEC also unanimously approved for release a proposed rule under the 1933 Act that would redefine "accredited investor" as it applies to natural persons investing in private investment vehicles, other than certain venture capital funds (the "Accredited Natural Person Rule"). This would include hedge funds relying on the Section 3(c)(1) exception from the definition of "investment company" under the Investment Company Act ("3(c)(1) Funds"), but not those hedge funds relying on the Section 3(c)(7) exception ("Qualified Purchaser Funds").

Under the current accredited investor rule applicable to private placements of shares of 3(c)(1) Funds, a natural person is considered an "accredited investor" eligible to invest in private offerings of such shares if that investor has a net worth of $1 million (inclusive of a residence), or $200,000 in income in the last two years, or $300,000 in joint income with a spouse (if investing jointly) in the last two years.[8]

In contrast, the Accredited Natural Person Rule would consist of a two-part test. The rule would include the same net worth/income test as before. However, the rule would also require that the investor hold $2.5 million in investments (exclusive of a residence), a requirement modeled on a similar requirement for investor eligibility for investments in Qualified Purchaser Funds. That second prong of the test would also contain an inflation adjustment: every five years beginning in 2012, the $2.5 million threshold would be changed and rounded to the nearest $100,000 based on the inflation rate over those past five years.

At the SEC's open meeting, the SEC staff and the Commissioners debated the applicability of the new Accredited Natural Person Rule to certain investors.

5 Proposing Release, *supra* note 1.

6 A fund relying on Section 3(c)(1) qualifies for the exception if it has not more than 100 investors and is not making or proposing to make a public offering. A fund relying on Section 3(c)(7) qualifies for the exception if, among other things, it is not making or proposing to make a public offering and its outstanding securities are held by persons who are "qualified purchasers" when they acquired those securities. "Qualified purchasers" include (1) any natural person owning at least $5 million in investments, (2) a trust not specifically formed for the purpose of investing in the fund relying on Section 3(c)(7) and of which the trustee or other person authorized to make investment decisions and settler is a qualified purchaser, and (3) any other person or company that owns or invests on a discretionary basis at least $25 million in investments. Investment Company Act Section 2(a)(51)(A).

7 The Proposing Release did include a few examples of frauds, including "false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to 'requests for proposals.'"

8 Rule 502(a) and Rule 215 of the 1933 Act.

Staff members noted that the current accredited investor definition applicable to 3(c)(1) Funds applies to investments in private equity funds *and* venture capital funds, but that the enhanced accredited investor definition would not apply to certain venture capital funds.[9] The staff explained that venture capital funds are vital in the funding of small start-up businesses. Accordingly, the Accredited Natural Person Rule would treat venture capital funds as essentially private business development companies.[10] Commissioner Atkins labeled this new, disparate treatment as a "political rationale."

Commissioner Campos noted that the new accredited investor rule would affect only a fraction of hedge funds, because most of them are Qualified Purchaser Funds. The Proposing Release also notes that the Accredited Natural Person Rule would not change the fact that a 3(c)(1) Fund may seek out 35 non-accredited investors for investment in the fund.[11] Moreover, Regulation D is an elective safe harbor, so private placements may be made without following its requirements.

Finally, of significant importance to current accredited investors is the applicability of the new standard to those already invested in hedge funds. The staff explained that eligibility as an accredited natural person would be measured at the time of investment. Therefore, those already invested in hedge funds would be grandfathered as to existing investments.

However, if those investors did not subsequently meet the requirements of the second prong of the test, they would not qualify as accredited investors when making any new investments in either the current fund or any other private fund. Furthermore, employees of a hedge fund manager who meet the current test but do not qualify as Accredited Natural Persons would no longer be able to invest in 3(c)(1) Funds (ironically, they would still be able to invest in Qualified Purchaser Funds), even if they would otherwise be knowledgeable employees, unless the manager was willing to grant the employee one of the 35 slots available in a 3(c)(1) Fund for non-accredited investors.

The SEC staff's primary rationale behind its new accredited investor standard seems to be an effort to limit the number of investors who may qualify to invest in hedge funds to those considered to be sophisticated investors. The value of a person's aggregate investment is presumed by the Accredited Natural Person Rule to be an appropriate surrogate for financial sophistication.

In the weeks following the open meeting, the enhanced accredited investor test came under strong criticism from small and start-up hedge funds that claimed they would bear the greatest burden under the new rule. They pointed out that a large percentage of new investment in hedge funds comes from institutional investors that would not be affected by the new rule. Thus, instead of having any meaningful impact on the number of investors who actually invest in hedge funds (as opposed to those who simply qualify to invest), the new rule would have a significant effect on start-up funds and managers creating their own funds.[12]

Although the two proposed hedge fund rules were unanimously approved for release, they also prompted much discussion and debate at the SEC's open meeting. Several of the Commissioners stressed that commenters should write in on a variety of aspects of the proposed rules, but most especially about any possible unintended consequences of the proposed antifraud and accredited investor rules.

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9 For purposes of the proposed hedge fund rules, the term "venture capital fund" would have the same meaning as the definition of business development company in Section 202(a)(22) of the Advisers Act. The term in that Section is modeled after the definition of business development company in Section 2(a)(48) of the Investment Company Act, with some modifications. *See* Proposing Release, *supra* note 1.

10 *Cf.* Sections 54-65 of the Investment Company Act giving special treatment of public business development companies.

11 Proposing Release, *supra* note 1.

12 "Little Guy Protected, But Not Little Hedge Funds," *Hedge Fund Daily,* 15 Dec. 2006; "Revised Hedge Fund Limits May Have Limited Impact," *Hedge Fund Daily,* 13 Dec. 2006.

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